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SUBJECT: Israel: Austerity Takes Hold [redacted] 25X1

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

18 March 1986

# Israel: Austerity Takes Hold [redacted] 25X1


## Summary

The Israeli economy appears to be responding strongly to the austerity measures imposed last July. Inflation has abated and foreign exchange reserves have improved, but at the cost of declining real wages and higher unemployment. While public reaction has been muted, pressures appear to be building for the government to assign greater priority to economic growth policies. Key economic issues on the agenda in the coming months--the budget, indexation, and tax reform--will test the resolve of the National Unity government. [redacted] 25X1

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The current austerity package has proved more effective than the National Unity government anticipated. The key elements of the 1 July program--new wage and price controls, a 19 percent shekel devaluation to be followed by a stable, though not formally fixed, exchange rate against the dollar, and additional deficit-reducing measures--were designed largely to slow the monthly inflation rate to a more tolerable 4 percent, dampen excess demand in the economy, and offset government overspending from the first few months of the fiscal year. By the end of the year, the program appeared to have achieved quite an impact:

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This memorandum was prepared by [redacted] the Israel-Jordan-Palestinian Branch, Arab-Israeli Division, Office of Near Eastern and South Asian Analysis. Information as of 18 March 1986 was used in its preparation. Questions and comments should be directed to Chief, Arab-Israeli Division [redacted]. 25X1 25X1


NESA M#86-20039

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--The monthly inflation rate slowed markedly, averaging under one percent for the last two months of 1985, while declining by about one percent in January of this year. The inflation rate for all of 1985 dropped to 184 percent, compared with the record 445 percent in 1984.

--Per capita consumption declined for the second year, largely because of falling real incomes. Real wages plummeted 19 percent during the second half of the year compared with the first half.

--The unemployment rate climbed to nearly eight percent by the last quarter of 1985--its highest rate in nearly two decades-- before falling slightly back early this year. Job losses were largely in the private sector, as the bulk of the layoffs planned for the public sector have yet to be implemented.

--The slump in domestic economic activity helped pare the civilian trade deficit by about $500 million in 1985. The reduced civilian trade deficit also slowed the drain on foreign exchange reserves. By yearend, the infusion of additional US aid boosted reserves from $2.4 billion to a comfortable level of $3.7 billion. [redacted] 25X1

## Why the Improvements?

The determination of Prime Minister Peres and the willingness of the Israeli consumer to shoulder additional hardships have been instrumental in helping the government program exceed expectations. [redacted] Peres [redacted] has stuck with the program and resisted demands by trade union leaders to ease up. His task has been made easier by the muted response of labor's rank-and-file. [redacted] 25X1 25X1 25X1 25X1 25X1

The Israeli public appears to have accepted leaner times in exchange for the unaccustomed stability resulting from slowing inflation. Much less time is now spent juggling financial assets or making purchases to hedge against rapid price hikes. In addition, consumers have postponed buying many durable goods--especially imported automobiles--and drawn on relatively high savings to help cope with lower real wages. [redacted] 25X1

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The government also has demonstrated a surprising ability to hold the line on expenditures. The sharp slash in subsidies under the July program helped put the budget back on track, and the government has since fended off most ministerial requests for additional funds. The fight to reduce the budget deficit also has been helped by revenue-enhancing measures: increased taxes on property and the self-employed, in particular, contributed to a 10 percent climb in real tax revenues last year. 25X1

The slowdown in domestic economic activity--especially the sharp drop in real wages--held off pressures for a further large devaluation of the shekel. Given the large import component of most Israeli goods, shekel devaluations--while reducing import demand by increasing their prices--have been strong contributors to the inflationary spiral. The shekel-dollar exchange rate held relatively steady over the latter half of the year, and the dollar's slide vis-a-vis the currencies of Israel's major European trade partners boosted Israel's export competitiveness. 25X1

## Tasks for 1986

The government now confronts the more formidable task of maintaining the current economic climate of austerity while introducing reforms needed to ensure continued progress. Several key economic issues on the agenda for the next few months will test the resolve of the government. They include:

--Budget deficit reductions. The most immediate concern is final Knesset passage of the budget for the 1986 fiscal year beginning 1 April. The budget proposes to slash the deficit by $600 million. Only $200 million, however, represents actual spending cuts--most of the reduction is the result of increased revenues, largely new user fees or levies. Some officials are also hoping to proceed with the sale of a few financially troubled government enterprises.

--Tax reforms. The government hopes to introduce some reforms at the start of the fiscal year. With government revenue approaching 50 percent of GNP, the tax burden is too high and taxes should be cut. By reducing marginal income tax rates, where the top rate is currently 60 percent, labor productivity will receive a needed shot in the arm. The government anticipates some initial tax revenue losses, but hopes

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to lessen the impact by continuing efforts to improve tax collection and by seeking to achieve real spending cuts so as not to add to the budget deficit.

--Indexation modifications. Finance Minister Modai already has publicly stated his intention to "deindex" the Israeli economy. Wages are likely to be tackled first because the existing indexation agreement expires at the end of March, and the government already has had some success in suspending indexation under its previous wage-price accords. The leader of Histadrut, the powerful trade union confederation, opposes deindexing wages unless financial assets are unlinked as well. The government has made some minor moves on this issue recently, but is proceeding cautiously. [redacted] 25X1

While some policies to help longterm growth would be helpful, too hasty a move at this time would only reignite high inflationary pressures and lessen the prospects for meaningful structural adjustments. Pressures already are building to pump up the economy. Some wage hikes are currently being introduced, which given the lower inflation rate will produce real wage growth over the next few months. But real wage growth in turn may translate into a higher monthly inflation rate. [redacted] 25X1

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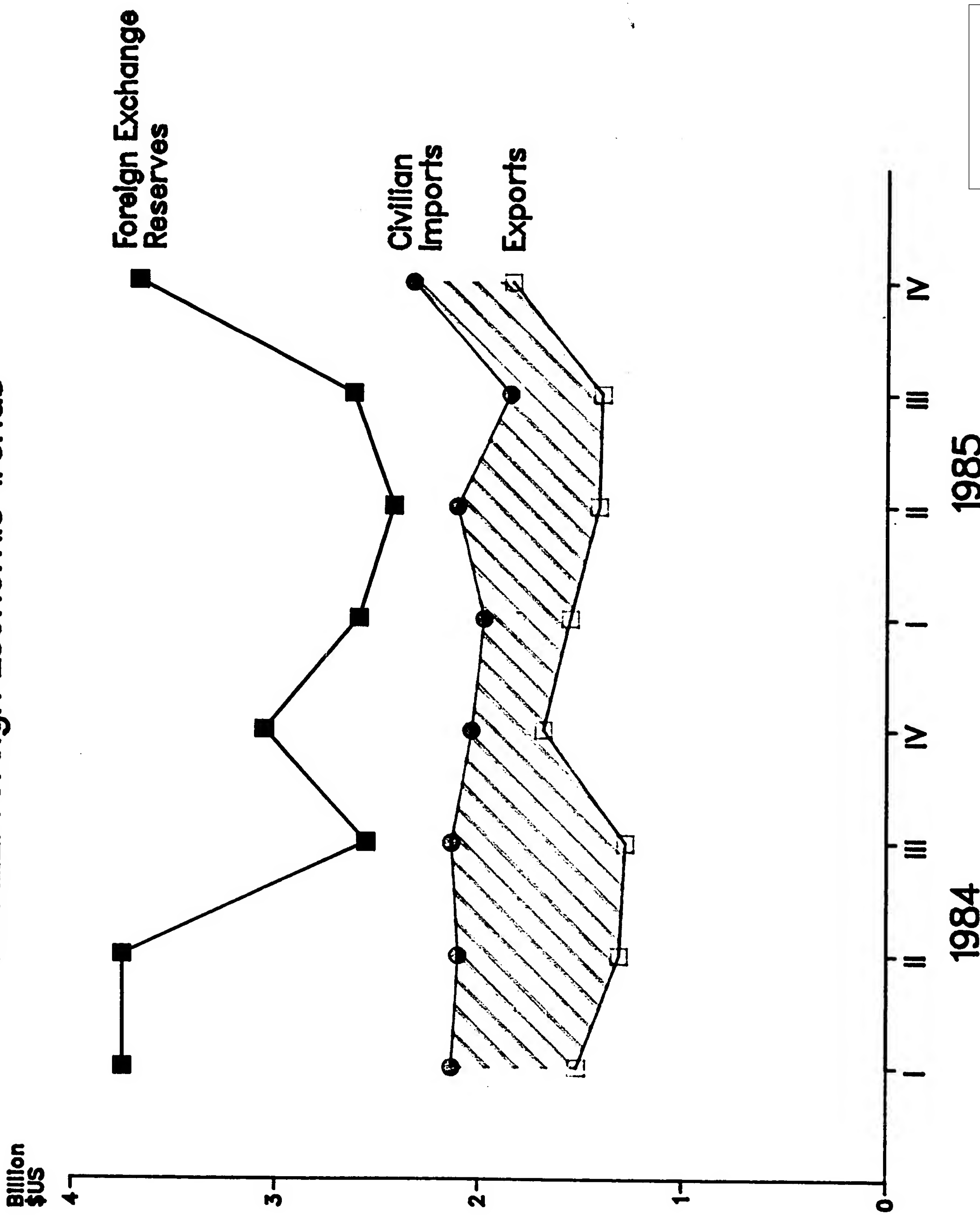
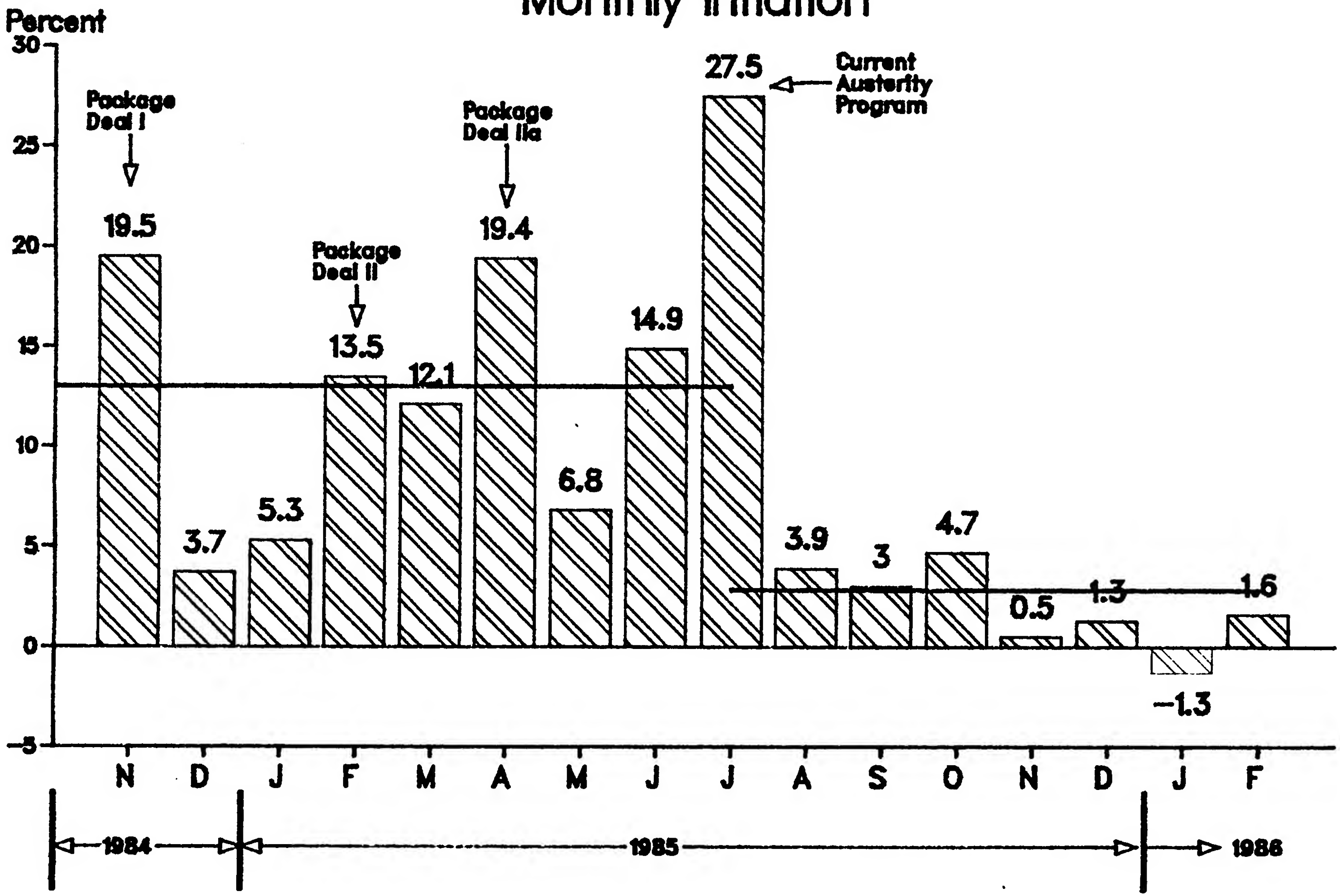
# ISRAEL: Foreign Economic Trends



# ISRAEL: ECONOMIC INDICATORS, 1984 — 1986
## Monthly Inflation

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# ISRAEL: Real Wages